

**Comrades In Arms: The Monopoly Control
Of Russia's Defence Industry By The Kremlin**

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Introduction

Under Russian President Vladimir Putin the personal financial interests of Russian state officials have become one with those of what they and the Russian president define as the national interest. The past few years have seen the slate of senior Kremlin officials take one of two steps in consolidating their control over the nation's most lucrative enterprises.

One option has been to take a commercial enterprise and by either using the power of the state to break up that firm or force its management to acquiesce control to one of Putin's acolytes. In some instances this has been accomplished by legal chicanery. After Putin had engineered the imprisonment of Yukos CEO Khordokovskiy, a mysterious and previously unknown tax bill for US \$27 billion was produced (which the company could not pay) in order to declare the company bankrupt. It was then sold in a rigged auction to an unknown investment firm that was a front for the Kremlin cabal under Putin.¹

The other mechanism that has been used has been for the Russian state arms export agency, Rosoboronexport (ROE), to take effective control of both defence and commercial enterprises by forcing these firms' owners to sell controlling packets of shares of their companies to the Russian arms export monopoly.

Both mechanisms have proven to be very effective. ROE now controls all of the enterprises that it set out to take over in June 2006 and is now assuming an ever-larger role in the Russian economy.

What bodes ill for the future of Russia's own domestic economic development and for its role as a player on the international arms market is the growing influence of ROE (and the KGB personnel associated with it) and their increasing power over the whole of Russia's major industrial enterprises.

This is not just an issue of the KGB in power and all of the negative connotations that go along with it. It is an issue of the forces now controlling Russia's defence industry – as well as large sectors of the commercial economy now – turning the whole of the country into their own private fiefdom. In the process they are taking steps that are inherently regressive and will exacerbate rather than alleviate the strains and problems of Russia's

¹ The arrest of Khordokovskiy not only allowed Putin's allies to take over the Yukos oil company, but also paved the way for the ouster of the remaining dominant figures that had been in the Kremlin under Boris Yeltsin. Putin's chief of staff, Alexander Voloshin, had been close to Yeltsin and some of the oligarchs like Khordokovsky. He refused to maintain the party line that Putin had no role in the prosecution of Khordokovsky and tendered his resignation in protest to the Yukos CEO's arrest. The resignation of Voloshin, who was a pro-business Chief of Staff and fought for improving Russia's investment climate, signaled the beginning of the era in which military and former KGB personnel came to dominate the Kremlin.

still developing market economy.

What is of perhaps a greater concern to US defence policy makers is that as the traditional markets for Russian-made weapons shrink, ROE and its allies within the Putin Government have embarked on three rather disturbing and potentially threatening courses of action.

One has been to expand the formerly semi-underground business of supplying arms to Iran, Syria and other less-than-responsible nations into a full-blown officially acknowledged effort to increase market share. Not surprisingly, in March when the UN Security Council enacted a set of embargoes against Iran - in response to Teheran's refusal to end its nuclear enrichment programme - Russia's representative refused to sign on to vote in favour of the sanctions until the codicil forbidding Moscow to sell weapons to Iran was stricken from the list. Arming some of these nations with weapons (that are much more state-of-the-art than the older-generation Russian systems that have been upgraded by Belarus) only serves to destabilise those regions that are some of the world's biggest problem zones.²



The second is to push for sales in nations that have not been clients of Russia in the past or to firm up relationships with nations that have been contemplating leaving the Russian fold and instead purchasing western weaponry. An example of the former is Hugo Chavez's Venezuela, which has made a large purchase of Russian weaponry and is now the first nation on the South American continent to have some of these advanced weapon

² Russia officially admitted to signing large arms export contracts with Iran in January, a little more than two months before the UN sanctions came into effect. This suggests that Moscow knew the sanctions were in the works and moved to put its business with Iran out into the open. Once in the open they would have grounds to oppose those sanctions without having to make a surprise announcement at the UN that they had plans to make more sales to Iran. See "Russia Sold Defensive Missiles to Iran," Vladimir Isachenkov, The Moscow Times, 17 January 2007.

systems in its inventory.

This in turn has prompted the Brazilian military, which traditionally has had the most modern and largest forces on the continent, to state that they must now modernise their armed forces with new hardware and that they must abandon this course they have been on for many years now of acquiring used systems. Not surprisingly, Brazil is now next on ROE's list of nations that they are trying to add to their stable of clients. Chavez, who has gladly taken on the role of being the champion for Russia's arms industry, has used his friendship with Brazilian president Luiz Inácio Lula da Silva to press for the Brazilian Air Force (FAB) to purchase the newest Russian fighter now in production, the Sukhoi Su-35.

An example of the latter scenario is the current competition in India for the Medium-Multirole Combat Aircraft (M-MRCA). India – in the eyes of ROE – is in some danger of leaving their flock of long-term valued customers. In order to prevent this from occurring, ROE have sent their two biggest promoters and allies – Putin and First Deputy PM Sergei Ivanov – on state visits to India to press the case for the Indians to purchase the MiG-35 over any US or European models. They have also lobbied behind the scenes and offered to pay bribes in order to change the terms of the Indian tender in a way that favours the Russian bid.³

The third course of action, which is less visible but no less ominous, is the slow but sure takeover of the entire arms design, production and sales process from front to back by ROE. For this agency to make the export sales of Russian weapons a single-agency monopoly is not that unusual. Russia has had – depending on which time during the past 17 years – between one and three arms export agencies and the issue of whether a monopoly or competition was better for this business has gone back and forth depending on the politics of the moment.

What is different about ROE in the present day is that it is now inserting itself into every stage of the defence industrial process. This creates a situation in which the arms industry is from its most early developmental stages focused on exports and making money for the Putin cabal – rather than designing systems that are in response to Russia's national security interests.

The present structure in which ROE plays an increasingly dominant role in the nation's economic and defence policy is one which is fraught with a number of unhappy consequences. It is a decidedly a system in which no one is looking towards the long-

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term developmental and infrastructure needs of either the country or the armed services. It is a system in which there is little – if any – thought given to military modernisation or reform.

Comrades In Arms: Putin's Chief Acolytes

The situation in Russia through the 1990s and even to some extent in the earlier part of this decade was one that has been aptly described as a time of asset stripping. With the election of Putin to a second term he made a decision to put a stop to this process. His idea was to brute force the thousands of enterprises in the defence industrial sector into a small number of mammoth conglomerates that his clique of former KGB colleagues and St. Petersburg lawyers could control. After Putin the two most important personages in this process and those responsible for maintaining that control are ROE's General Director Sergei Chemezov and Ivanov.



Putin's legacy with both of them goes back a number of years. Ivanov has been a colleague of the Russian president since they were both young, up-and-coming KGB officers in the 1970s. As Putin's star rose in the system under Yeltsin - and then later as he ascended to the presidency - he brought Ivanov along with him. First, as a national security advisor, then as Minister of Defence and now as First Deputy PM.

Ivanov's concept of what belongs to the state and what should be controlled by the state is a throwback to the Soviet years. In 2003 when commenting about the energy sector he stated that:

"The state, in my view, should not lose control over all the strategic branches of industry. This does not mean encroaching on their activity, but it must control them, know the situation, and understand in what direction these branches are developing. . . . If we do not begin to invest significant state funds in exploration in the next few years, we risk having to cope with serious consequences in the coming 10-15 years. The state, knowing the situation, can make balanced decisions about investing funds for geological exploration in one or another region of the country, taking into account companies' development plans, and then conduct open licensing for the exploitation of these deposits. This is something that the state must do, because in recent years we have become convinced that

private companies will not invest in exploration work. Besides this, minerals and resources are state property, not private. Therefore the state has the full right to control this process and manage it in the interest of the entire country's development."

Ivanov's philosophy about what belongs to Caesar was recognised as being one with Putin's ideas about the Russian state increasing its control of strategically important industries. The Russian President has since suitably rewarded his trusted aide with several high-level appointments.

Aside from making Ivanov Defence Minister in 2001, Putin made his colleague the head of a new (or, more accurately, reincarnated) body called the Military Industrial Commission (MIC), which was to coordinate and control the actions of the defence industrial sector. When the entirety of the aircraft industry was merged into one large conglomerate called the Unified Aircraft Company (or OAK in its Russian acronym), Ivanov was then made the Chairman of the Board. All of which made sure that he was the man with his hand on the helm of the defence industrial sector and could be trusted to see that – as he said in his statement above – that the "state should not lose control."



While Ivanov is minding the front end of the arms industry the back end – the export process – is controlled by Chemezov. The ROE General Director became acquainted with Putin in the early 1980s when they both were assigned intelligence postings in the former German Democratic Republic (GDR). When Putin became Russian President, Chemezov was soon appointed to the board of the Sukhoi aircraft company. Later he participated in the management that formed the Almaz-Antei air defence consortium.

In April 2004 Chemezov became the General Director of ROE and began the process of firming up total control of the arms export business. Until 1 March of this year there were several Russian firms that had their own licence to sell abroad without ROE's involvement. But as of the beginning of March, ROE will have absolute power in all arms sales and all of the proceeds will flow through them. This is a level of control that no organisation – not even during the Soviet years – has ever enjoyed. It is the culmination of the total control of the arms export process by Putin's allies and closest aides.

Milking The System

Putin's clique is slowly moving all valuable assets of the country – energy, metallurgy, automotive, and defence industry – into organisations where the Russian state is the owner of these vast holdings. These massive conglomerates were supposed to create economies of scale and synergism in the R&D process in order to revitalise the Russian defence industry.

But, this structure that Putin and others have advocated is not based on any data that would lead one to the conclusion that this type of vertically-integrated structure makes for increased efficiencies and production. It is instead based on a blind faith in centralisation. And, following the argument logically, if some degree of state control and a centralised structure does not produce the desired result then the answer is automatically more state control and more centralisation.

Observers of the Russian defence industry have pointed out that while the worldwide trend has been for firms to consolidate and become large corporate behemoths – like Lockheed Martin or Raytheon in the US – that there is no evidence that the Russian state is able to act as a reliable and competent manager of these resources. Most of the defence industrial reorganisation plans that have been attempted since 1991 have ended in failure. The state-appointed managers have shown their inability to manage such massive industrial formations.

Not surprisingly, the state's answer has been to reinforce that failure rather than to look for another model of organisation or management.

At the same time there has been little or no demonstrated progress in terms of ROE's ability to expand export sales and return profits to the firms that have produced those products that do sell.

According to reports by the Russian Federation's Audit Chamber, only 10-20 factories of the 1,700 defence plants in Russia ever received actual export orders from ROE. In 2001 it contributed only 4 percent of the agency's income to the state budget, despite a law called for it to hand over 10-50 percent. The same Audit Chamber complained that not only were "irregularities" in ROE's financial procedures apparent, but that the framework of its activity was so convoluted it defied meaningful control.⁴

⁴ "Enter Rosoboronekspert," Alla Kassianova, Program on New Approaches to Russian Security, Policy Memo No. 406, Center for Strategic and International Studies, Washington, DC, 2006, p. 2; "Chief Arms Exporter to Oversee Defense Contracts," p. 5.

There have also been many such complaints from both inside and outside of the defence industrial sector about how this portion of the economy is managed. One Russian newspaper described it as "the most problem-ridden, closed, and bureaucratic sector of the economy," and stated that "not one of the many programs designed to reform it thus far has yielded any results."

This begs the question of what is the purpose of more centralised control within the defence industry and a dictatorial reign over the arms export business. Not to mention why is the only agency allowed to make a foreign sale of arms being run by Chemezov – a man whose sole qualification for the job seems to be that he has been good friends with the Russian president for a quarter of a century.

The answer is that the whole idea behind this arrangement that Putin and his colleagues have set up is all about control – and only control. Control reigns supreme over all other considerations – efficiency, cost-effectiveness, quality, cost-competitiveness, etc. Control means that all the president's men can milk the system for everything that it is worth in ways that no other previous Russian or Soviet leader had ever dreamed possible.

Interlinkages

Milking the system – in the context of what Putin and those around him are engaged in – means something far more than just the asset stripping of the 1990s. It means using ROE in conjunction with the other assets now controlled by the state in order to try and extend Russia's imperial reach.

What many observers of Russia do not realise that Putin did not go about consolidating this control in order to just stop the asset stripping of the 1990s. What he is seeking is a more effective and augmented version of that asset stripping. Asset stripping is now operating on an entirely new level, but where it is a means to an end and not an end in itself.

In this new model for taking maximum profits from the assets that the state now controls, those same industries that are now state-owned are the keys to an interlinked programme for reaching out to those nations where they can be employed to maximum advantage. In order to do this Putin needs a set of completely obedient and controllable industries so that his henchmen can put together megadeals that involve some or all facets of these state-controlled enterprises.

There are numerous examples of how Putin and company have managed this "perfect storm" of finding where the interests of the Russian state and other nations overlap with those of the arms industry and other enterprises controlled by the Kremlin. The most prevalent of those involves a deal made last year by the Russian president in Algeria.

How Gas And Oil Make For Good Weapons Business

The Algerian arms export deal was culminated on 10 March 2006, was finalised – not surprisingly – when Russian President Vladimir Putin took a delegation of defence and energy representatives to Algeria as part of his official entourage on a state visit. The delegation was able to conclude several interlinked defence and energy agreements, the most important of which was a deal between Gazprom, Russia's mammoth gas export state monopoly, and Algeria's state-owned energy company Sonatrach. Sonatrach is also one of the international pioneers in the design and technology of liquefied natural gas (LNG) terminal development.

It is this LNG technology this is the key to this Algerian contract. Russia's prime motivation in this deal is *not* to sell more aeroplanes, tanks and missiles, but to find a non-Western source for the technology needed to begin building its own LNG facilities. This is critical to the future business and export revenues of Gazprom, which is probably why during the visit Putin met with Algerian President Abdel Aziz Bouteflika for the purpose of writing off nearly \$5 billion of Algeria's debt, saying that Russia was more interested in trade with Algeria than debt repayment.

In the background there were top-level meetings taking place between Alexei Miller, the CEO of Gazprom, and the senior officers of Algeria's state-owned energy company Sonatrach. The two companies not only signed a memorandum of understanding (MOU), but Miller also planned to return to Algeria in April to begin setting up the framework for the companies' long-term cooperation.

On the surface, being willing to sell all of these weapons to Algeria, forgive such a huge debt obligation, and to be courting its state energy firm would seem to be counterintuitive path for Russia to take. Although Sonatrach provides 90 percent of Algeria's export earnings by distributing about 60 billion cubic metres of natural gas a year, most of it to Europe, it small fry compared to Gazprom. With Sonatrach being the major partner for Europe, which is not happy with Russia after the energy price disputes with Ukraine and Georgia that took place in early 2006, the partnership does not make much sense politically either. In addition, Algeria competes with Russia in the European energy market, which would put both countries fishing in the same pond, so to speak.

The reason for Russia's aggressive courtship is that Algeria has the key technology that Russia needs in order to build liquefied natural gas (LNG) facilities. Gazprom have long wanted to create an LNG capacity that would allow Russia to export LNG virtually anywhere in the world. The problem has been the cost of doing so.

The only way to turn natural gas into LNG for transport is to cool it down to minus 300 degrees Fahrenheit at a liquefaction facility and load it onto specially designed tankers. Once it reaches its destination, LNG is offloaded at regasification facilities, heated and fed into a standard natural gas pipeline network. France, Belgium, Italy, Spain, the United Kingdom, Greece, Portugal, Turkey, Japan, India, South Korea, Taiwan and the United States all import LNG using their own facilities.

Gazprom is especially eager to have LNG technology so it can finally move into its Barents Sea natural gas reserves, which hold some 10,000 billion cubic metres of natural gas. This technology would also give Gazprom more control over the Sakhalin-2 project, where Royal Dutch/Shell is in charge of building an LNG facility that has been in the works since the latter half of the 1990s.⁵

Gazprom has previously tried to obtain the technology to build LNG facilities by working with the usual Western suspects, major energy companies like Shell, ConocoPhillips and Chevron Corp. However, the Russian position has been – as it always is with Moscow – is that they want something for nothing.

LNG technology is not cheap, so rather than spending the money to set up a liquefaction facility on their own, Gazprom expect one of these large companies to pay to build this facility in Russia out of their own pocket as a buy-in to the Russian gas market. Understandably, these companies, who know how much building an LNG facility actually costs, (something in the neighbourhood of US \$4-5 billion) have told Gazprom that they are dreaming if they think this sort of charity is in the cards for the Russian natural gas giant.

These energy companies are also aware of the Russian tactic as of late that calls for a large western firm to be lured into setting up a large, expensive facility on Russian territory by visions of super profits in the future as the payoff for the investment. Then once the facility is finished and paid for with other people's money the Russians

⁵ Not surprisingly, the Russian state is now using various nefarious measures to pressure Royal Dutch/Shell into renegotiating its share of the production agreement that has been in place since the Sakhalin-2 project began. It is typical of Russian partnerships with foreign firms that they will try and use any subterfuge that is available as soon as they think the foreign partner is making "too much money." See "Shell Faces Sakhalin Stumbling Block," Valeria Korchagina, *The Moscow Times*, 19 September 2006.

generally find a way to steal control of that facility from the western partner. Most recently, Russia has prevented the largest single western investor in their energy section, Bill Browder, from returning to Russia. His visa was revoked on the grounds that he was a "threat to national security," which basically means that he was in the position to make some money off of Russia's energy market and Moscow instead want all the proceeds for themselves. Part of the new order with Putin is that no one outside of his circle – especially any foreigners – are allowed to make any money off of Russia.

The western energy giants are also not eager to team with Gazprom because of the Russian energy giant's increasing monopoly control over Russian resources (including its nefarious attempts to keep western investors out or cheat them out of the funds they have invested) and its energy disputes with Europe, which have shaken the European energy market. At the same time, it is this not so friendly relationship with Europe that has Gazprom seeking alternative resources and partners.

It is Algeria's standing in the LNG market that makes it such a good partner for Gazprom. Algeria became the world's first LNG producer with the startup of the Arzew GLAZ plant in 1964, and the country is still the world's second-largest LNG exporter behind Indonesia. Algeria say that they will not just give Russia the technology *gratis* and that Gazprom will have to pay for the LNG facility, but the Russian gas giant is much more comfortable in working with Sonatrach – and paying them for the LNG technology – for two reasons.

1) Making this deal with Sonatrach can keep western energy firms out of the Russian LNG business – at least temporarily – and lock in the money flow between Russia and its new weapons customer in Algeria.

2) Like Gazprom, Sonatrach are state-owned and operated. This means that the state-owned Gazprom can propose government-to-government multi-faceted deals that offer up defence sales and debt write-offs as part of a semi-countertade deal in which Russia gets its hands on this expensive LNG technology.

Needless to say, selling such a large quantity of weapons to Algeria also gives Russia some tremendous leverage over the North African Country. Should Algeria get into some dispute with Russia in the future over LNG profits the Russians could always threaten to cut off supplies of spare parts for those weapon systems. It has happened before with other nations, and it could easily happen again with the Algerians.

[Just getting a deal with the Algerians for the LNG technology does not get Gazprom all the way to its goals. Barriers to Russia's independent LNG production will still remain, the most prevalent of which is that Sonatrach have the technology to build an LNG

terminal but do not manufacture the raw materials required to build these terminals. These would have to be purchased from a Western company. Furthermore, Moscow's gas reserves in the Barents Sea will require a partner that has a handle on this equally complicated technology. Norway, although a competitor with Gazprom, is one of the world's leaders in offshore natural gas exploration technology. Gazprom could conceivably make a deal with them, but there would still be the ever-growing problem of European tensions over Russia's attempts to play games with its gas valve into the west.]



But, LNG is only one part of this deal. Russian oil companies will also be given the rights to explore and develop some new Algeria oil fields. Combined with the LNG projects that are being proposed, the value of these oil exploration rights make it possible for Russia to almost give these weapons away.

The total value of the arms package for Algeria is \$7.5 billion and includes 26-50 MiG-29SMT-9.17/47 fighters (depending on how many options the Algerians intend to exercise) and 28 Su-30MK fighter jets – plus several batteries of the Almaz-Antei S-300PMU2 (SA-10) air defence system and a fleet of Uralvagonzavod T-90S main battle tanks. When all is complete with these export orders, Algeria will eventually account for 20 percent or more of Russian defence exports.⁶

⁶ The Su-30MKs for Algeria are expected to be very similar to the "Islamic" configuration that has been sold to Malaysia, the Su-30MKM. These aircraft will be produced at the Irkut plant, which is where the current RSK-MiG GD, Aleksei Fedorov, spent most of his career. The same plant also produced the Su-30MKI for the Indian Air Force, but this configuration includes components made by Israeli firms, which is not acceptable to the Algerians. Fedorov is now the General Director of the new OAK – Unified Aircraft Company – and is one of the few industrial managers in the Russian defence industry who is truly competent and effective. However, he has been instructed by Ivanov and others that he is to have a secondary role in the defence exports business from now on. Only the president's men are now to be in the lead on these type of contracts.

This is the real goal of the Putin cabal. To have a mechanism for generating huge profits out of the state-controlled industries, but to do so in such a way that the products and services of these industries reinforce each other. These symbiotic relationships play into each other in a way that allows these type of multi-faceted trade agreements such as the Algerian deal to be organised. In the end, the main beneficiaries are Putin's entourage - from the financial point of view.

But from the political point of view the other beneficiary is the Russian state - at least in a short-term sense. In the case of both the Algerian and Venezuelan defence sales the power of Russia to maintain a strong hand in the energy market has been enhanced. New markets for Russian weapons have been opened up. New alliances have been developed between Russia and states that are unfriendly to the US.

"Within the global economy, the principal requirement is to be strong and competitive; otherwise, you'll be devoured," Sergei Markov, a political analyst and Kremlin consultant, wrote in an article late last year. "Vladimir Putin's policy is becoming increasingly clear - to promote the creation of a pool of major Russian companies that could become global players. That would enable Russia to preserve the independence of its economy and, amid free competition, to save the choicest morsels of the Russian economy from being acquired by foreign multinational corporations."⁷

All of this is looked upon as positive by the Putin Administration, but what they are ignoring - of course - are the long term consequences of their actions.

The Downward Spiral

The first of these consequences is that this band of "Comrades in Arms" has managed to take control of so many big money-making enterprises that they now are afraid that the gravy train will end once Putin leaves office. This has been the driving force behind the calls for Putin to remain for a third term. No one in his inner circle and from among his chief supporters (which also includes those who have benefited most from his rule) wants to think about a world without Putin as the chief executive. 'What would happen next?' is the question that none of them want to contemplate.

This is the first consequence, which is the death of anything resembling a democratic process or free elections.

⁷ "Kremlin, Inc. Widening Control Over Industry," Peter Finn, *Washington Post*, 19 November 2006.

Critics of Russian President Vladimir Putin charge that he is attempting to reinstitute much of the dictatorial and heavily centralised authoritarianism of the Soviet state, but without the tight ideological controls of that era that mandated what was taught in schools and what could be written in open publications. People are more or less free to say and do what they want today. That is, as long as they do not jeopardise the Kremlin's total control over the major money-making activities of the country. This has earned the Russian president the nickname "Putinchet" in some circles.

But more damaging are the consequences for the Russian economy as a whole and the future of the defence industrial sector in particular.

The state takeover of many of the money-making sectors is an effective renationalisation of these key industries. It is complete abrogation of the 1990s goals of privatisation, which was a pillar of Russia's efforts to become a market economy after the collapse of the Soviet Union. The drive to put property in private hands stemmed from a belief that such companies would be more efficient and attractive to investors – much more so than the industrial enterprises of Soviet times that were notorious for being unmanageable.

Many of these firms have been forced to fall under state ownership again, most notably the firm VSMPO-Avisma, which makes much of the world's aircraft grade titanium and has signed a multi-billion joint venture with the Boeing company in the US. Last year they were taken over by ROE in a scenario that is typical for big businesses that fall under the watchful eye of Putin's inner circle.

The two main owners of the firm, Vladislav Tetyukhin, 73, and his partner, Vyacheslav Bresht, had privatised the company and made it into a world market player in the titanium industry. They initially resisted the "we are making you an offer you cannot refuse" from ROE to sell their shares to the Russian arms agency, but then they found themselves under investigation by the tax police. Then the prosecutor's office launched an inquiry into VSMPO-Avisma's share structure. (Before it was acquired by VSMPO, Avisma, which is a raw materials supplier, was owned by the former Yuoks CEO Khodorkovsky, which is a potentially dangerous connection given what Putin did to ruin both Yukos and its chief executive.) The full force of all the coercive power of the state soon made the two owners realise that they had to submit to the inevitable.

ROE justified its shotgun-point acquisition by saying it planned to move into the metals industry to "prevent the enterprises of the metallurgy sector from being usurped by various organisations, including those acting in the interests of foreign capital and using illegal methods."

But after REO took over the firm all of the concerns about foreign capital soon vanished when it became obvious how much of it was available. In August 2006, Boeing and VSMPO signed a contract for supplies of titanium and semi-finished products worth \$18 billion over 30 years.

"The state has decided it's time to gather all the stones that were cast away - it's all according to the Bible," said Tetyukhin, "They told me that for the state it will make sense to have everything in one fist."

According to Tatyana Stanovaya, a senior analyst at the Center for Political Technologies in Moscow, the Kremlin, Inc. team is also looking at new acquisitions in the energy business as well as diamond extraction, metallurgy and machine building.

"The state wants reliable people to head these corporations, loyal, patriotic people who will be very different from owners of the 1990s and act for the national interest as the Kremlin defines it," said Stanovaya, in an interview with the *Washington Post*. "And that coincides with the concrete interests of individuals around Putin who strengthen their own economic position as property is redistributed," she explained.⁸

Critics of Putin's regime state that this is another inevitable consequence of his administration's personnel make-up, which consists largely of these former KGB colleagues and the group of St. Petersburg lawyers like the other First Deputy PM, Dmitry Medvedev.⁹

It is not much of a surprise to those who have watched the Putin administration evolve in its second term to see this type of consolidation of power. It is consistent with the practice during the Soviet times that the intelligence services controlled anything that made money, and this tendency has only expanded now that there are no competing power centres such as the Communist Party or large ministries who demand their share of tribute as well.

This arrangement is breeding a new generation of cynical careerists and those who look for every chance for the state to expropriate some enterprise or industry that can be designated as being "taken over by the state in the national interest." It is the exactly the

⁸ Ibid.

⁹ Sergei Chemezov, the current General Director of ROE, is not the only KGB officer who served in the former DDR at the same time as Putin. The other member of this Cold War DDR triumvirate is Andrei Belyaninov, who used to be the director of ROE and now runs another massive money-making government machine: the Customs Service. He, Putin and Chemezov have been close friends ever since those days. But, having Belyaninov in charge of Customs is another insurance against any difficulties involving arms exports.

type of kleptocratic tendency of the Soviet times that was so counterproductive to the development of a properly functioning economy.

At the same time, there are those in that political hierarchy who believe that this type of centralised control can be their key to gaining more power - in addition to modernising the Russian economy.

One of the many features of the Putin regime that is a holdover from the Soviet times is the interlocking memberships that its major players have in both government and industrial positions. As mentioned earlier, Ivanov wears a number of hats, and he now is attempting to use his positions as Chairman of the Board of the OAK and Chairman of the MIC as his power base to becoming president.

The MIC under Ivanov is literally becoming a massive administrative body that far outstrips just the responsibility of managing the defence industry, even in some cases competing with the Presidential Administration. He now holds so much power that he had been able to bypass the PM, Mikhail Fradkov - even though he as a Deputy PM should in theory report to Fradkov. (Being one of the President's best friends and the head of a monstrous defence industrial empire is more important than titles in this Russian government.)

And, Ivanov is probably one of the greatest bureaucratic empire builders that has been seen in the post-Soviet era. As Stephen Blank of the Army War College's Strategic Studies Institute writes about the MIC in his exhaustive study of ROE:

"In effect, the MIC will have a privileged and unquestioned priority in that budget which is unaccountable to any legislative or regular governmental scrutiny. Instead, the defence order remains an economic and budgetary charge accountable only to the President personally and to his direct line of command down through Ivanov. Here again, we see that the entire defence sector and the industries it will control, as part of what might be called the President's personal government, have been removed from any kind of governmental or Parliamentary oversight."¹⁰

Removing the entire defence industrial sector of the economy from any sort of oversight is a rather reckless move, considering that it still contains about 75 per cent of the nation's scientific-technical R&D and engineering facilities and personnel. But, what is even more reckless is the idea that Ivanov is now propagating, which is that the defence

¹⁰ Rosoboroneksport: Arms Sales And The Structure Of Russian Defense Industry, Stephen J. Blank, US Army War College, January 2007, p. 58.

industrial sector can be the saviour of the Russian nation's economy.

Ivanov has recently declared that Russia's defence industries – and not the commercial, private enterprise sector – will be the key to breaking Russia's dependence on gas and oil exports and modernising its economy. "Generally, there is every reason to call the military-industrial complex the locomotive of diversification," has said at a meeting of Russia's Public Chamber that was held in April at Moscow's prestigious Baumann Institute.

Ivanov's rationale for calling the defence and aerospace sectors the "locomotive" that will decrease energy exports' share of the country's overall foreign trade revenue is that defence products currently constitute 30 percent to 35 percent of total domestic production. Military industries will "re-establish Russia as a strong, thriving and influential government," he has said.

However, there are many who are sceptical of Ivanov's bold new vision for the future. Programmes in the past to try and utilise defence industrial prowess in the commercial sector have ended up being comical failures. Most of the resources of the defence sector that have been directed towards commercial projects have ended up being a horrendously expensive waste of resources.

This idea runs counter to the dynamics of current-day technological development. Almost all of Russian aerospace and other high-tech production is related to defence, as opposed to in the US and in Europe where the majority of the high technology sectors are devoted to commercial production. This sector produces commercial-off-the-shelf (COTS) innovations that are now the primary building blocks of weapon systems in the west. There are almost no spin-offs from the defence sector into the commercial sector. It is instead the other way around.

In short, it is a dangerous move to fill peoples' heads with the idea that the defence sector can revitalise the economy. Not only is it untrue, but to manage the defence industry in this way – in order to try and generate innovation throughout the entire nation as a collateral benefit - only guarantees a worse than normal result from this sector of the economy.

Conclusions

The only step more dangerous to Russia's future than moving all of the defence sector under state monopoly control is to also then expropriate portions of the commercial sector of the economy to be placed under the same controls. Unfortunately, this is what

Russia's leadership is now doing by placing more and more commercial firms under ROE.

This continuing belief in the magical power of centralised control – particularly in 21st century – calls into question just how much the present Russian Government knows about the economic dynamics of the modern age. It is almost as though they had stepped back into the Soviet practice of attempting to change laws of human behaviour, nature and economic forces by decree.

Commensurate with this unfortunate state is the continuing problem of no proper incentives and capitalisation sources for small and middle-size businesses. Without this sector there can be no proper growth in the Russian economy.

Such actions will only cause to drive away what little interest there remains by foreign firms to invest in Russia. The combination of incompetent and sclerotic centralised management and no foreign investment is guaranteed to render the country's industry to a state of permanent obsolescence.

As industry become less and less capable of generating innovations and products that can compete in the outside world, Russia will be driven to more rather than less dependence upon its gas and oil and mineral extraction. These businesses will become more and more the focus of Russian foreign policy, as the Kremlin seeks to use the few levers it has left to exert its influence.

Just as has already happened in Algeria and Venezuela, there will be an even greater push to use energy deals in conjunction with military exports in order to open up new markets for arms sales. There will be significantly increased pressure put on industry to turn out more sellable arms, as these will be one of the few money making products left in Russia.

Russia will end up abandoning all cooperation with the US and others in exercising restraint in arms sales. As it becomes more desperate to expand markets and earn hard currency, ROE will begin to sell to anyone anywhere who is willing to pay regardless of the nature of the regime making the buy.

None of these changes will work towards making Russia a better partner for the US and EU, and Russia will become less – rather than more – responsive to the norms of the international community.

A former - and now deceased - US Ambassador to Moscow once remarked to me that the main characteristic of how the Soviet Union conducted itself in the international arena was that they had turned the main tenet of the famous German military strategist

Clausewitz on its head and always behaved as though "politics was the continuation of war by other means." There is no reason not to believe that Putin and whoever succeeds him will not carry on in this tradition.

When Russia began to deteriorate economically in the 1990s and the war drums began to beat in the Middle East against Iraq everyone dreaded that would be catastrophic twin consequences of these cataclysms. Namely, that they would cause a return to a regime in Russia like the Soviet Union and that oil would end up costing more than \$60 a barrel.

What we are likely to end up with in Moscow is a situation far worse. A nation that does not even behave with half of the consideration for the realpolitik of the outside world as the USSR did is most likely, along with oil prices that continue to cause huge economic upheavals. All the while the regime in the Kremlin will continue to try its repetitively failed attempts at creating economic growth by centralisation. When this fails to produce the desired result the answer will be – as one would expect – "let's try to export more weapons."